HALOS, FRACTURES, RIGOUR MORTIS, CLONING, EXTERNAL INSTRUMENTS AND COMPANIES LIMITED BY GUARANTEE

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INTRODUCTION

John Friedrich and the insolvent National Safety Council Victorian Division (NSC) provided the popular press with the right mix of a manhunt, spies, fraud and odd characters to break circulation records. Public interest in the matter spawned two `quickie' books about the mysterious Friedrich and the Council.[1] When a judgment was delivered making one of the directors of the Council personally liable, academic writers were also handed good copy for law journals and a swag of industry magazines.[2] Friedrich and the NSC inspired commentators of all ilks to grind out thousands of words on all facets of the fraud from fanciful spy connections to the liability of directors.

This paper strikes a different pitch as a considered reflection on the regulation of nonprofit entities. It seeks a broader ken than permitted in a legal case note and a more considered view than the popular press. It utilises material gained not only from the case reports, but newspapers and administrative records obtained through freedom of information requests. It places the case not within a context of extrapolating the formal law or copy to sell tabloids, but the broader theoretical and practical issues of regulating nonprofit companies. This has been largely neglected in the literature to date.[3]

The paper introduces the reflection on nonprofit entities by briefly outlining the history of the NSC case. Secondly, it reviews the response of the media and the corporate regulators to the issue of the regulation of nonprofit companies. The third part of this paper provides an analysis of the regulatory issues that administrators face when dealing with nonprofit entities. This last part of the paper draws on a wider context incorporating experiences from the American and English jurisdictions.

PART ONE - THE NATIONAL SAFETY COUNCIL VICTORIAN DIVISION

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[1] J. Friedrich & R. Flanagan, *Codename Iago - The Story of John Friedrich*, William Heinemann Australia, Melbourne, 1991; M. Thomas, *The Fraud - Behind the Mystery of John Friedrich, Australia's Greatest Conman*, Pagemasters Pty Ltd, Melbourne, 1991.

[2] J. Jason, `The Strange Case of John Friedrich?', *New Dawn*, Vol.1, No.5, 1991, pp.5-7; A.S. Sievers, `The National Safety Council Case', *Company and Securities Law Journal*, Vol.9, No.5, 1991, pp.338-343; A.S. Sievers, `The Honorary Director: The Obligations of Directors and Committee Members of Non-profit Companies and Associations', *Company and Securities Law Journal*, Vol.8, 1990, pp.87-109; A.S. Sievers, Recent Developments in the Liability of Directors and Committee Members of Non-profit Associations, Working Paper No.7, QUT Program on Nonprofit Corporations, 1992; M. McGregor-Lowndes, *Limited by What? Guaranteed to Whom?*, *Criminology Australia*, Vol.2, No.1, 1990, pp.2-4; N. Bushnell & M. Summons, NSCA Debacle Changes the Charity Game, Australian Business, Vol.9, No.23, 1989, pp.20-21; G. Hattam & C Richards, `The Friedrich Case', *Communications Law Bulletin*, Vol. 10, No.2, 1990, pp.13-14; S. Long, *Commonwealth Bank of Australia* v. *John Friedrich, Eise & Others*, Queensland Law Society Journal, Vol.21, No.4, 1991, pp.347-350; R. Baxt, `Publicity and Accountability', *Australian Business Law Review*, Vol.18, No.3, 1990, pp.193-195; M. McGregor-Lowndes, `Doing Good is No Excuse in Company Law', *Legal Service Bulletin*, Vol.16, No.6, 1991, pp. 279-281; M. McGregor-Lowndes, `Guaranteeing Safer Companies', *Legal Service Bulletin*, Vol.14, No.4, 1989, pp.164-167; P.J. Booth, `Problems with Liquidators', *Law Institute Journal*, Vol.63, No.9, 1989, pp.808-809; G. Batemen, `Have you got $97 million to spare?', *Australian Accountant*, Vol.61, No.10, 1991, pp.32-34, 37; K. Lees-Amon, `A Local Community Counts the Cost in the Wake of the NSCA Collapse', *Australian Municipal Journal*, Vol.68, No.1026, 1989, pp.312-313; B. Bottom, J. Silvester, T. Noble & P. Daley, *Inside Victoria, A Chronicle of Scandal*, Pan Macmillan Publishers Australia, Melbourne, 1991.

[3] One exception is the last section of A.S. Sievers, `The Honorary Director: The Obligations of Directors and Committee Members of Non-profit Companies and Associations', *Company and Securities Law Journal*, Vol.8, 1990, pp.87-109.

The National Safety Council Victoria Division was a company limited by guarantee incorporated in 1928 with a license by the Attorney General to omit the word "limited" from its name.[4] It was formed by a coalition of Victorian nonprofit agencies with the charitable object of promoting safety awareness, particularly industrial safety.[5] The company never lodged any accounts with the regulatory authorities and only sporadic notices of office bearers.[6] It had exemptions from income taxation and gifts to the company were tax deductible.

Membership of the company was open to all willing to subscribe to the memorandum and articles and pay an annual subscription of one guinea.[7] All members had an equal vote to elect a council of five members and 42 specified organisations had the right to appoint a representative to the council.[8] The specified organisations included a range of government agencies (police, fire service, railways) and nonprofit organisations such as chambers of commerce, car clubs, trades unions and some private companies (Ford). The Council appointed an executive committee consisting of a President which they elected and then representatives from 14 named associations. This membership structure will be commented on later in this paper as one aspect in the collapse.

The NSC carried out safety awareness programs with an emphasis initially on the workplace but expanding to road and leisure activities. It was funded through government grants and industry contributions, relying on volunteers to perform most of its functions. In 1962 the Council fostered the establishment of similar organisations in the other states of Australia which became separate corporate entities. It was at this time that the NSC began to contract a safety service to industry specialising in on-site training and safety auditing. In 1979 it began to develop emergency services with the purchase of a fire tender.

In 1982 under the charismatic leadership of its chief executive, John Friedrich, the organisation expanded into providing exotic forms of search and rescue.[9] Its expansion was funded through commercial loans from financial institutions secured over sealed containers of rescue equipment. Most containers were empty and thus the security illusory. The accounts of the organisation were also tampered with to show a better position, often in the form of illusory debtors. There is also a suggestion that auditor's reports qualifying the accounts were tampered with by the chief executive before presentation to the board and lenders. The matter was brought to a head when the board requested an independent financial assessment and the chief executive fled. The company was placed

[4] It was originally registered on the 9th February, 1928 as the "National Safety Council of Australia", but changed its name in 1961 to "National Safety Council of Australia Victorian Division".

[5] The company also had public benevolent institution status under Section 78 of the *Income Tax Assessment Act* 1936 (Cth.) which permits donations over two dollars to be an allowable deduction from the donor's assessable income.

[6] A search of the Victorian Corporate Affairs records reveals that returns of officers were lodged in 1941, 1986 and 1988.

[7] Clauses 3, 4 & 5 of Articles of Association, dated 9 February 1928.

[8] Clause 8 of Articles of Association, dated 9 February 1928.

[9] For example the organisation had a stable of horses for search operations in rugged terrain, parachute teams to go to remote locations, firefighting planes, helicopters and even a rescue submarine.

into liquidation owing over three hundred million dollars.

PART TWO — RESPONSES OF THE POPULAR PRESS AND ADMINISTRATORS

In the thousands of tabloid column inches written about the fraud, little focussed seriously on matters concerning the regulation of nonprofit entities. One editorial of the Australian Financial Review is quite perceptive and poses some very relevant questions about the regulation of nonprofit companies.[10] It pointed out that the company was unrestrained by any effective corporate affairs or taxation office supervision, or any other government body, the Council was too large, uninterested, and met too infrequently to be an effective control of management and the organisational structure was neither `fish' nor `fowl'.[11] The editorial called for an investigation of other companies with a similar structure and questioned whether publicly available information on such organisations was not the first step to a proper regulation of such nonprofit companies. These matters will all be addressed in later sections of this paper.

The other issue which deserves to be noted from the popular press is that they had heralded the possibility of a fraud over a number of years. These articles proved to be fairly accurate in hindsight. For example, in August 1988 Channel 10's *Page One* expressed concerns about the NSC and its operations, a local paper, the Bairnsdale Advertiser, as early as 1986 outlined extensive misgivings about the financial status of the NSC[12] A large feature article in the *Sydney Sun Herald* by Wendy Bacon in October 1988 noted its accounts were puzzling, the company was unaccountable to the public and discrepancies existed between equipment purchased and income received.[13]

To this was added direct complaints to various authorities who were in a position to investigate the matters raised. The chair of directors produced evidence of irregularities to the Commissioner of Police in October, 1988.[14] The Victorian Treasurer was aware the NSC had prepared false invoices for 1.3 million dollars to the Victorian Government in November, 1988.[15] The Federal Defence Department which had dealings with the NSC was alerted at departmental officer and Ministerial level in 1987 about irregularities in funding of the company.[16] The Victorian Corporate Affairs Commission received a written complaint in December, 1988 about the company, but the Commissioner was reported as saying that, "he was inhibited from acting because of a lack of hard

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[10] *The Australian Financial Review*, 28 March, 1989, The Lessons of the NSCA Scandal.

[11] Id.

[12] *The Sunday Mail*, 26 March, 1989, Story Was Just Too Hot and B. Bottom, J. Silvester, T. Noble & P. Daley, *Inside Victoria, A Chronicle of Scandal*, Pan Macmillan Publishers Australia, Melbourne, 1991 at p.157.

[13] W. Bacon, *Sydney Sun Herald*, 2 October, 1988 in an article entitled Death, Intrigue in the World of Skydiving.

[14] *The Australian*, 28 March, 1989, How Victoria's Police let the NSC Chief off the hook,

[15] *The Australian*, 29 March, 1989, Jolly blamed for disappearance, p.4.

[16] *The Australian*, 27 March, 1989, Beazley had NSC warning, p.1.

evidence."[17] No regulatory authority appears to have seriously investigated the complaints raised either in the media or by individuals and this again will be commented on later in this paper.

After the collapse of the NSC, the most visible first response of the Victorian Corporate Affairs Commission was to write to all companies that had Section 66 licenses in Victoria to request a copy of their last audited financial statements. The Commission could contact only sixty-two per cent of the companies on their register.[18] Of those companies that replied twenty per cent did not have an audited financial statement as required by the Act and fifty-six per cent failed to comply with the accounting standards.[19]

A similar survey by the author in the previous year of Queensland companies limited by guarantee revealed strikingly similar results.[20] This study included all companies limited by guarantee in Queensland and showed substantial default rates for the lodging of annual returns.[21] Companies limited by guarantee had a default rate of some fifty-two per cent with thirty-one per cent being more than one year in arrears, and four per cent being more than ten years in arrears.[22]

Such default might be common for any registry, but the available data on commercial corporate registers is significantly lower. Yum in 1979 found Victorian proprietary limited companies had an annual default rate of twenty-five per cent.[23] In 1988, the National Companies and Securities Commission issued eighteen per cent of commercial companies with late penalty notices for lodgement of annual returns.[24] In comparison for the same period, Queensland incorporated associations had a less than twenty percent default rate, but the Act had only been passed five years earlier and more than half the associations had not been registered for more than two years.[25] There is a growing body of empirical evidence that nonprofit and charitable entity registers are characterised by greater levels of default than commercial registers.[26]

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[17] N. Bushnell & M. Summons, *op. cit.*, at p.21.

[18] This report is not public and was obtained by the author pursuant to a Freedom of Information Application. The report is dated 17 August 1989 from The Victorian Commissioner of Corporate Affairs to the Victorian State Attorney-General and to be found in the file of the National Safety Council - Victoria Division.

[19] *Ibid*., at p.3.

[20] McGregor-Lowndes, *op. cit.*, at pp.91-94.

[21] M. McGregor-Lowndes, Regulatory Compliance of Two Forms of Nonprofit Enterprise, unpublished master's thesis, Griffith University, 1989.

[22] *Ibid*., at p.81.

[23] D.C. Yum, Control of Exempt Proprietary Companies - A Case for Change, unpublished master's thesis, University of New England, 1984, at p.74.

[24] Commonwealth of Australia, National Companies and Securities Commission Annual Report, 1989, Canberra, Australian Government Publishing Service, at p.16.

[25] *Ibid*., at p.143.

[26] For example in Australia refer to D.J. Williams & J. R. Warfe, *The Charities Sector in Victoria - Characteristics and Public Accountability*, *Accounting and Finance*, May 1982, pp.55-71; M. McGillivray, C.A. Romano & D.J. Williams, *op.*

The tangible results of the Victorian Commissioners activities were that deregistration proceedings were instigated against companies that did not reply to the Commissioner's request.[27] About twenty companies were encouraged to migrate to the incorporated associations register immediately[28] and only one formal investigation of a company initiated.[29] The Commissioner also wrote to a number of companies advising that their account exemptions would be removed. The Commission departed from the National Securities Commission handbook on such matters by devising criteria which quantified a level of commercial dealings over which it was not initially prepared to permit non-lodgement of accounts.[30]

The Commissioner also recommended to the Ministerial Council for Companies and Securities in September 1989 that section 66(5) of the Companies Act 1981 be repealed there by deleting the capacity to exempt companies from the requirement to lodge annual accounts.[31] This had largely been effected by administrative means where it was administrative policy not to grant section 66(5) licenses since 1986.[32] The following tables indicate the license granting patterns of the Queensland Corporate Affairs Register.

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cit., pp.307-317; M. McGregor-Lowndes, C. McDonald & D.Dwyer, `Public Fundraising Charities in Queensland', Working Paper No.14, Program on Nonprofit Corporations, Queensland University of Technology, Brisbane, 1993, at pp.18-19; New South Wales, Chief Secretary's Department, *A Review of the Charitable Collections Act*, 1934, Sydney, 1989, at p.5; R. Radich, `An Analysis of the Differences in Audit Processes Used in the Audit of Nonprofit and Profit Organisations', Working Paper No. 19, Program on Nonprofit Corporations, Queensland University of Technology, 1993; and in England, M. Austin & J. Posnett, *The Charity Sector in England and Wales - Characteristics and Public Accountability*, Institute of Social and Economic Research, Department of Economics and Related Studies, University of York, Reprint Series, No.281, 1980, at p.3; Charities Aid Foundation, *Report on Foundation Activity*, London, 1976, at pp.6 & 21; Great Britain, Monitoring and Control of Charities in England and Wales, National Audit Office, HMSO, London, 1987; Great Britain, Committee of Public Accounts, 7th Report, HMSO, London, 1991, at p.vii; and in America, K.L. Karst, `The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility', *Harvard Law Review*, Vol.73, No.3, 1960, at pp.433-658 at p.456; United States of America, Report of the Commission on Private Philanthropy and Public Needs, Giving in America: Toward a Stronger Voluntary Sector, Commission on Private Philanthropy and Public Needs, Washington, 1975, Volume 5 at p.115; State Regulation of Charitable Trusts and Solicitations, The National Association of Attorneys General, Committee on the Office of Attorney General, Washington, 1977; Nonprofit Quality Reporting Project, *Enhancing The Quality of Public Reporting by Nonprofit Organisations*, New York, 1991, at p.11.

[27] Memo from Commissioner for Corporate Affairs to Victorian Attorney General dated 17 August, 1989 at p.2.

[28] *Id.*

[29] *Ibid.*, at p.1.

[30] Contained in a letter from The Deputy Commissioner of Corporate Affairs to Mrs A.S. Sievers, dated 14 February, 1990 which were 1. external creditors in excess of $50,000, a turnover in excess of $200,000, receipt of government grants, bequests or donations in excess of $20,000.

[31] Ministerial Council Paper prepared for the Victorian Attorney General for submission at the Ministerial Council for Companies and Securities September, 1989, at p.4.

[32] Minutes of section 66 meeting held on 6 and 7 February, 1986, item 2. At that meeting representatives from Victoria and the A.C.T. argued for statutory repeal of the section with Queensland and New South Wales pointing to the considerable opposition of vested interests.

TABLE 1
Date of Exemption or Licence of Section 66 Companies*
Queensland Register

Year of Licence	*66AD*	*66EA*	*66ED*	*66NE*	*Total 66*	*Total Reg*
1989 - 1908	1	0	0	5	6	12
1909 - 1918	0	0	0	5	5	7
1919 - 1928	1	0	0	7	8	9
1929 - 1938	0	0	0	5	5	9
1939 - 1948	0	0	0	14	14	18
1949 - 1958	0	0	0	17	17	33
1959 - 1968	28	14	5	12	59	64
1969 - 1978	25	9	50	16	100	304
1979 - 1988	1	0	10	13	24	544

* Only companies which are registered currently or deregistered since 1984 formed the sample.

TABLE 2
Classification of Section 66 Licence *
Queensland Register 1978 - 1988

Year of Licence	*66AD*	*66EA*	*66ED*	*66NE*
78	0	0	6	2
79	0	0	2	0
80	0	0	2	3
81	0	0	4	3
82	0	0	1	1
83	0	0	1	1
84	0	0	0	1
85	0	0	0	1
86	1	0	0	0
87	0	0	0	1
88	0	0	0	2
Total	**1**	**0**	**16**	**15**

* Only companies which are registered currently or deregistered since 1984 formed the sample.

Section 66AD - This company has a section 66 "limited" licence and is exempt from the lodging an annual return, return of directors, principal executive officers and secretary.

Section 66EA - This company has a section 66 "limited" licence and is exempt from lodging

an annual return.

Section 66ED - This company has a section 66 "limited" licence and is exempt from the lodging return of particulars of directors, principal executive officers and secretary.

Section 66EA - This company has a section 66 "limited" licence but no other exemptions.

The advent of the Corporations Law and the Australian Securities Commission continued a response to the issues raised in the National Safety Council fraud. The Corporations Law contained Section 383 which was substantially similar to section 66 of the Companies Code. However, it did omit the provisions concerning the exemption of certain companies from lodging returns of officers and annual accounts.[33] Section 383(11) purported to save licences already granted to companies before the commencement of the Corporations Law. Licences to omit the word "limited" from the name of a company are saved but it is not clear whether the licences for return of officers and accounts continue.

The initial position of the ASC was that past licences were saved.[34] The opinion was formed that Section 383(11) preserved all licences granted prior to the Corporations Law. It would not include exemptions given to a company which were by way of notice in writing rather than being included in the formal licence.[35] These exemptions were saved by the operation of state scheme legislation.[36]

However, the ASC completely reversed its opinion in October, 1991 and formed the view that all licences had been revoked.[37] Arrangements were made to send a letter to all companies that had previously held such licences requiring an immediate return of office bearers to be lodged together with an annual audited accounts.[38] This reversal appears to have been made after a telephone conference with a Melbourne QC in July, 1991[39] and an internal ASC Commission meeting in September.[40] These documents have not been made available to the author under freedom of information and are subject to appeal. The interpretation of the ASC of Section 383(11) could be capable of a serious challenge on several grounds, but that requires much more space than is available

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[33] Formerly section 66(5) Companies Code.

[34] Internal memorandum from Legal Division to Manager Registration Procedures Business Operations Division, dated 27 May, 1991 and circulated to ASC Business Offices on 12 June, 1991.

[35] It appears that this is the situation in the case of the NSC. The initial licence related only to the word "limited" and exemption from returns and annual accounts may have only been by a written notice which does not appear on the official public registry file of the company.

[36] For example Section 85 of the Corporations Law (State) Act.

[37] BOPS Newsletter No.37.12.

[38] Letter from Hartnell dated 19 October, 1991.

[39] Disclosed in written communication from the FOI Officer ASC, Melbourne to the author dated 28 February, 1992.

[40] *Id.*

here.[41]

At the same time, the letter to all formerly licensed companies limited by guarantee was sent, a policy statement about section 383 was released by the ASC.[42] This policy statement was replaced in July 1992[43] and again in March 1993.[44] The Commission has gradually refined the conditions upon which it will grant licences.

The ASC as a matter of policy will only licence companies limited by guarantee rather than share capital companies. There is a policy of restricting the ability of directors to be remunerated from the company for their services on the basis of enforcing the nondistribution constraint.[45] This policy is currently providing problems for such companies wishing to take advantage of the new section 241 and 241A insurance provisions. This is because section 234K deems the insurance premiums paid by a company for the officer of a public company to be remuneration incurred by that officer. At the time of writing the ASC had not formalised their policy on such matters. The policy also sets down criteria on which to assess whether the commercial activities of the company are significant and hence should not be permitted to trade without the word `limited' in its name. The reasoning is that potential creditors should be aware its liability is limited.

The policy overcomes a number of problems which have haunted such company regulation for many years and will be further identified in the later sections of this paper. The ASC is are requiring all licences to be surrendered and new licences issued. In previous regulatory regimes old licences were not updated, as illustrated in the NSC case. Further, once the licence has been granted there is an obligation for the company to ensure it keeps within the terms of the licence and notify the ASC of any alterations. The ASC it is actively monitoring the situation. Queensland ASC Business Office is taking a particularly pro active stance in reminding company limited by guarantee's controllers of their responsibilities.

There are a number of concerns in the policy statement that should be noted in passing. The policy claims that the origin of the original exemptions for such companies was the Companies (Literary Institutions) Act 1883. The work of the author[46] and more extensive recent work of Levy[47] present

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[41] Apart from the argument originally proposed by the ASC legal officers recourse could be had to the explanatory memorandum clause 1366 which on one interpretation suggests that previous licences would continue, the provisions of sections 7, 8 and 50 of the Commonwealth Acts Interpretation Act, the cases of *Total (Australia) Limited* v. *Registrar of Companies* [1969] VR 821 and *Byrne* v. *Garrison* [1965] VR 523, Sections 1349 and 1328 of the Corporations Law.

[42] Policy Release no.11, Revocation of a licence under s383.

[43] Policy Statement 29: Issue and Revocation of a Licence under Section 383 authorising the omission of the word `limited' in company names.

[44] Policy Statement No.50, Authorisation under Section 50 to omit `limited' from a company's name.

[45] The nondistribution constraint is a term first used by Henry Hansmann to describe the common restraint of a nonprofit entity in distributing profits to any person or purpose other than its sanctioned objectives. Refer H.B. Hansmann, `The Role of Nonprofit Enterprise', *The Yale Law Journal*, Vol.89, No.5, 1980, pp.835-898; H.B. Hansmann, `Reforming Nonprofit Corporation Law', *University of Pennsylvania Law Review*, Vol.129, No.3, 1981, pp.497-623.

[46] McGregor-Lowndes, *op. cit.*

cogent evidence this act played only a minor role in the legislative origins of the provisions. This will be taken up later in this paper.

The issue of director remuneration can also be debated on good policy and economic grounds. Volunteer directors are not necessarily appropriate for some nonprofit entities. This debate has been raging in the United Kingdom and the United States. Remuneration of directors may bring a host of advantages that overcome the incompetence displayed by many directors of charitable organisations.[48]

At this early stage, it is difficult to assess what effect the policy and its implementation is having on the regulation of companies limited by guarantee. The default rates of companies limited by guarantee are not included in the annual statistics provided by the ASC and the policy of full cost recovery for record searches used in academic studies has meant that this will be difficult to ascertain in the future. The tables below are constructed from the ASC and NSC Annual Reports and do disclose the last two years have seen over 1,400 companies limited by guarantee deregistered. This is the most dramatic clean up of the registry of companies limited by guarantee ever seen in Australia and it is to the credit of the ASC. The studies of the Victorian and Queensland registers mentioned earlier would suggest there are yet still more defaulting companies which could be struck from the register.[49]

TABLE 3
Total Companies Limited by
Guarantee Registered by State

	1985	*1986*	*1987*	*1988*	*1989*	*1990*	*♥1991*	*1992*	*1993*
A.C.T.	226	241	264	272	—	318	354	373	376
New South Wales	4,382	4,519	4,666	3,826	4,854	4,893	5,054	4,881	4,679
Queensland	817	846	918	955	986	1,012	1,077	1,056	1,041
South Australia	48	48	49	57	59	72	87	100	98
Tasmania	223	231	239	♦244	99	108	260	265	259
Victoria	818	♣(756)	975	♣(1,854)	♠2,046	928	1,913	1,916	1,748
Western Australia	57	63	68	74	83	40	72	86	89
Northern Territory	—	7	8	10	—	14	12	14	14
TOTAL	6,571	6,711	7,187	7,292	8,127	7,385	♠8,829	8,691	8,304

Source: NCSC Annual reports. ♦ The 1988 Annual Reports shows Tasmania as having 88 Companies registered by guarantee but this appears to be a mistake. The figure of 244 comes from the Tasmania C.A.C. annual 1988 report. ♣ The figures from Victoria in 1986 and 1988 are estimates only. ♠ Includes companies limited by shares and guarantee. ♥ The figures for 1991 combine a 6 month NCSC Report and a six month ASC Report.

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[47] K.J. Levy, *An Historical Analysis of Incorporated "Non-profit" Entities in the United Kingdom, New Zealand and Australia with the Purpose of Raising the "Profit/Non-profit Debate"*, Minor LL.M Thesis, University of Melbourne, 1993 and K.J. Levy, *Should Section 383 of the Corporations Law Still Exist in 2001?*, A paper presented at the National Corporate Law Teachers Conference 1994, Sydney.

[48] McDonald, *op. cit*.

[49] The author searched 49 Queensland companies limited by guarantee in December 1993 and found that over half were still in breach of their annual return lodging requirements.

TABLE 4
Yearly Incorporation of
Companies Limited by Guarantee by State

	1985	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*
A.C.T.	22	18	23	8	22	29	24	27	196
New South Wales	219	105	111	♥137	156	124	113	149	173
Queensland	37	34	55	36	60	47	66	73	77
South Australia	2	—	7	8	10	5	8	12	6
Tasmania	7	11	13	5	12	9	15	12	6
Victoria	56	55	49	69	78	73	♦28	59	85
Western Australia	6	6	5	6	9	9	8	9	7
Northern Territory	—	—	8	10	0	2	2	1	3
TOTAL	349	229	271	279	347	298	♠264	342	376

Source: NCSC & ASC Annual Reports. ♥ Includes companies limited by shares and guarantees. ♦ Victoria could only report 1 January 1991 to 30 June 1991, this figure is thus understated by probably fifty per cent. ♠ Note total affected by ♦ understatement.

PART THREE — SOME REFLECTIONS ON THE REGULATION OF NONPROFIT AND CHARITABLE ENTITIES

This part seeks to place the NSC case within a broader framework of the regulation of nonprofit entities. It identifies a number of themes concerning the regulation of nonprofit entities which range across Australian, American and English jurisdictions. The Australian Securities Commission has implemented a practical response to the previous regulatory failure of companies limited by guarantee, but it lacks any apparent insight into the systemic flaws which contributed to that failure or a clear vision as to the systemic reform which could benefit the regulation of such entities.

The following part examines the fractured nature of regulation of activities of nonprofit entities and that situation's contribution to promoting regulatory failure. The behavioural response of administrators to nonprofit entities which have what will be described as a `halo' is established and its ramifications explored. The priority of the regulation of such entities for administrators and politicians is also identified as contributing to regulatory failure. Finally, the patterns of formal legislative reform is examined for its part as well as the inappropriateness of regulatory instruments.

FRACTURED AGENCIES

"Fractured administrative agencies" describes the situation where no one agency of the state takes prime responsibility for the regulation of the organisation. Evidence in the National Safety Council case study lends support to the notion that fractured administrative agencies contribute to undetected fraud. The national agencies that could have possibly been involved with the regulation of the

National Safety Council were National Companies and Securities Commission and the Australian Taxation Office. The Victorian agencies were, Victorian Corporate Affairs Commission, Victorian Attorney General, charitable fundraising regulators, and various government departments.

Flowing from English legal traditions, the Victorian Attorney General has the inherent *parens patriae* jurisdiction to supervise, protect and control charities. The National Safety Council had objects which if it were in the legal form of a trust would have been classified as charitable.[50] There is no evidence it was a trustee for significant property as part of a charitable trust. On the face of it the Attorney General would have no direct jurisdiction to intervene. However, an unresolved issue in Anglo-Australian law results where the corporation has only charitable objects. The issue is whether such a company is perceived as in a position analogous to a trustee to its own property or ordinary corporate relationships remain unchanged. The English judiciary has started to develop some charitable trust principles in the context of the corporation.[51] The evidence indicates that the Attorney was not interested in investigating the matter.

The Australian Tax Office could have some regulatory role over a company such as the NSC. The evidence points to no income tax returns ever being filed by the NSC.[52] It is common for the ATO to actively discourage those organisations with an exemption from income tax under Section 23 from

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[50] Evidence for this is to be found in the fact that the organisation was found to qualify for exemptions under sections 23 and 78 of the Income Tax Assessment Act and section 66 of the Companies Code.

[51] Tudor notes on the basis of comments in *Liverpool and District Hospital for Diseases of the Heart v. Attorney-General [1981] Ch. 193*

> With regard to the general property of a charitable company, the better view would seem to be that it is not subject to a trust in the strict sense but holds it subject to a binding legal obligation to apply it for charitable purposes only; the position of a charitable company in relation to its assets is, therefore, "analogous" to that of a trustee. S.G. Maurice, D.B. Parker, Tudor on Charities, *op. cit.*, at p.410.

Warburton argues that as the property is vested in the company and not the directors, so directors are to be more accurately described as "quasi-trustees or fiduciaries." J. Warburton, `Unauthorised Acts by Charities', *Trust Law & Practice*, October, 1987, pp.46-50 at p.48. She asserts that the Liverpool case may allow "the courts to apply full equitable remedies in the event of misapplication of charitable property." This assumes that it is in fact charitable property, which is different from directors or the company acting in a fiduciary like manner.

In England the Charity Commissions have been statutorily given jurisdiction to supervise such companies.Section 46, *Charities Act* 1960 (U.K.) and section 35A *Companies Act* 1989, (U.K.); J. Warburton, `Charitable Companies and the Charities Act 1992', *The Charity Law & Practice Review*, Vol.1, 1992-3, pp.203-208; J. Warburton, `Charity Corporations: The Framework for the Future', *The Conveyancer and Property Lawyer*, Vol.54, 1990, pp.95-105. In America, the drafters of the Model Nonprofit Corporations Law expressly rejected the doctrine "that corporations formed for charitable purposes hold their assets in trust for stated purposes at the time of acquisition of the respective assets and that the directors are trustees with respect thereto."

The matter has been indirectly addressed in the Australia courts through the issue of whether a gift to a charitable corporation is a gift in trust or a gift to the corporation generally for its objects. Although the decisions espoused differing judicial views, it appears that a disposition to a charitable corporation will presumptively take affect as a trust for the purposes of the corporation rather than a gift to the corporation. *Re Inman* [1965] V.R. 258; *Sir Moses Montefiore Jewish Home* v. *Howell and Co, (No.7) Pty Ltd* [1984] 2 N.S.W.L.R. 406 and Victoria, `Report on Charitable Trusts', Chief Justice's Law Reform Committee, Melbourne, 1965 at p.26; H.A.J. Ford, `Dispositions for Purposes', in *Essays in Equity*, ed., P. Finn, Law Book Company Limited, Sydney, 1985 at p.168.

[52] *Commonwealth Bank of Australia* v. *Friedrich & Ors.* (1991) 9 ACLC 946 at p.960.

lodging a return. In other jurisdictions the taxation authorities are theoretically relied on heavily to regulate nonprofit entities. The American Internal Revenue Service (IRS) has been perceived as the federal institution which could regulate such bodies, given the lack of response from the state Attorneys General. After the Filer Commission, Congress increasingly used the IRS as a policy tool to attempt to control nonprofit entities.

The Victorian Corporate Affairs Commission was described in the major litigation about the NSC as the prime regulator. The judge found that in some years, no annual meetings were held,[53] and accounts or reports were not presented to members. The judge considered the fraud would not have occurred, "if there had been compliance with the fundamental provisions of the [companies] Code."[54]

The conclusion of several Victorian inquiries about the regulation of charities and nonprofit entities were that regulation of charities through a core administrative agency was not required because of other regulatory agencies, particularly those which provided registration of corporate status.[55] Such faith was not vindicated in the performance of the regulators of the National Safety Council.

The situation of the NSC can be generalised to the regulation of most charitable entities. The regulation of nonprofit entities by these fractured agencies is peripheral to their core missions and key constituencies. The regulation is also increasingly fractured, with little co-ordination in theory or practice. There is evidence that this is even the case in respect of the seemingly centralised English Charity Commission. These two issues mitigate against efficient and appropriate monitoring and control in turn promoting regulatory failure.

The fractured nature of regulatory agencies is notable in American and Australasian jurisdictions. Nonprofit entities are regulated by over seventy separate Australian federal statutory provisions representing nearly ten federal administrative agencies. This welter of administrative agencies pales when compared to the number of statutory provisions and agencies in the states. For example in New South Wales there are over 230 statutory provisions and fifteen administrative agencies. None of these agencies have a core mission to regulate nonprofit entities.

While it may appear that England is firmly in the grip of a central lead agency, this is not entirely the case. Chesterman predicted in 1979 that the English regulatory regime of the Charity Commissioners,

> *... is likely to be increasingly overshadowed by other distinct legal regimes, such as housing law, within which the supervision of government-subsidised charities will fall increasingly to specialised government departments and agencies, such as the Housing*

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[53] *Ibid.*, at p.975.

[54] *Ibid.*, at p.979.

[55] Victoria, Victorian State Government Interdepartmental Working Party, `Administration of Charities', 2nd Report, Victorian Government Printer, Melbourne, 31 March 1982 at p.69; Victoria, `Review of Health Legislation', Discussion Paper No.8, Health Department Victoria, 1987, Victorian Government Printer, Melbourne, at p.6.

Corporations.[56]

This was confirmed by the Chief Commissioner of the Charity Commission who stated in an interview,

> *Moreover, in these days when many other government departments were providing grants, subsidies, and fees to a wide range of charities, these other departments might be said to have a greater incentive, and indeed a greater responsibility, to check positively that public money was not being wasted through mismanagement or misconduct on the part of charities.*[57]

State agencies which provide grants to nonprofit entities have been pressured towards greater accountability of those grants. Rather than relying on other state agencies charged with the responsibility of ensuring the fidelity of such entities, state donor agencies have adopted their own fidelity measures. This usually amounts to replication of filing of audited financial returns. These returns, if scrutinised, are usually vetted by staff without accounting or regulatory experience, an experience singularly lacking in state welfare agencies. One different strategy has been to load this expense on to the nonprofit entity by making funds contingent on extensive private auditor's reports whose costs are borne by the entity.[58]

These donor agencies are likely only to be interested in the entities they use to transfer property and only in the state property transferred. Entities without a relationship with such agencies will not be regulated by such agencies and other state property transfers activities may not be regulated. To abdicate the responsibility of the state for ensuring fidelity of entities to donor agencies has serious implications.

The actions of these donor agencies in not accepting the state fidelity assurance mechanisms for the transfer of property is also a comment on the actual state of the regulation of entities. As Ellman suggests of American states, states are unwilling to bear the transaction costs of making contacts, and monitoring and enforcing contracts for gratuitous property transfers for donors.[59] Such incentives to duplicate, largely ineffective controls may not be so great if donor agencies could rely on a body such as the Charity Commission to achieve a reasonable standard of regulation. It may also mean considerable savings for both the state and nonprofit entities for there to be one competent lead administrative agency, acting as an information broker.

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[56] M. Chesterman, *Charities, Trusts and Social Welfare*, Weidenfeld and Nicolson, London, 1979, at p.386 and this is again repeated in similar terms at p.406.

[57] J. Douglas and P. Wright, `English Charities, Legal Definition, Taxation and Regulation', Program on Nonprofit Organisation Working Paper No.15, no date, Yale University, New Haven, at p.50.

[58] For example the *Queensland Art Unions and Public Amusements Act* (Qld, 1992) Regulation 21 or 1992 Skillshare Auditor's Package, Department of Employment Education and Training, Canberra, 1992.

[59] I.M. Ellman, `Another Theory of Nonprofit Corporations', *Michigan Law Review*, Vol.80, 1982, pp.999-1050 at p.1015.

The fractured nature of nonprofit entity regulation encourages a number of behaviours which promote regulatory failure. The first, identified by Professor Henry Hansmann in relation to the IRS performing a role in the enforcement of the nondistribution constraint of nonprofit corporations, was that the IRS "have at best only a indirect interest in policing the fiduciary behaviour in nonprofits."[60] He continues,

> *to be sure the IRS, must necessarily police transactions of all sorts to ensure that those upon whom taxes are levied actually pay them. But strict enforcement of the nondistribution constraint among tax-exempt nonprofits will generally not lead to an increase in federal revenues; rather, it will simply ensure that less of the nonprofit's income goes to its managers and more goes to further their purposes for which the patrons have contributed funds. Burdening the revenue system with such non-tax objectives threatens to confuse its mission and dilute its effectiveness.*[61]

Krever writes in a similar tone that,

> *A tax expenditure program is also administratively inefficient because it transfers to tax officials responsibility for supervising programmes in areas in which they have no expertise or experience. Tax assessors and auditors are trained, in the first instance, in accounting and income measurement skills. They have no qualifications in social welfare or the related areas to which the charitable gifts expenditure is directed.*[62]

Similar remarks have been made by inquiries in England,[63] the United States,[64] New Zealand,[65] and Australia[66] about regulation by the taxation agencies.

Secondly, fractured agencies cause those who are charged with the responsibility of regulation within these agencies of regarding it as low priority, a backwater eddy compared to the main flow of the

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[60] H.B. Hansmann, `Reforming the Nonprofit Corporation Law', *op. cit.*, at p.604.

[61] *Id.*

[62] R. Krever, `Tax Deductions for Charitable Donations: A Tax Expenditure Analysis', in *Charities and Philanthropic Institutions: Reforming the Tax Subsidy and Regulatory Regimes*, eds. R. Krever & G. Kewley, Comparative Public Policy Research Unit, Monash University and Australian Tax Research Foundation, Melbourne, 1992.

[63] Great Britain, National Audit Office, `Monitoring and Control of Charities in England and Wales', Cmd. 380, HMSO, London, 1987 at p.12.

[64] United States of America, `Report of the Commission on Private Philanthropy and Public Needs, Giving in America: Toward a Stronger Voluntary Sector', Commission on Private Philanthropy and Public Needs, Washington, 1975 at p.2577 (hereinafter referred to as `Filer Commission').

[65] New Zealand, `Report to the Minister of Finance and the Minister of Social Welfare by the Working Party on Charities and Sporting Bodies', New Zealand Government Printer, Wellington, 1989 at p.34.

[66] Victoria, Victorian Legal and Constitutional Committee, `A Report to Parliament on The Law Relating to Charitable Trusts', Victorian Government Printer, Melbourne, 1989 at p.39.

agency's responsibilities. In a matching of resources to responsibilities, low priority regulatory responsibilities will suffer. In Queensland, for example the *Annual Report of the Justice Department*, a department which administers five acts concerning regulation of charitable fundraising, reconstruction of failed charities and registration of corporate nonprofit entities, contains only one paragraph that merely acknowledges responsibility for the statutes.[67] The Annual Reports of the Australian Securities Commission which incorporates nonprofit entities, registers nonprofit bodies that trade across state borders and exempts them from compliance with parts of the legislation, contains no statistics or comments on exemptions or interstate nonprofit registrations.[68] These reports indicate the lack of importance placed by the administrators on their responsibilities for regulating nonprofit organisations. This theme of backwater policy environments and lack of resources will be further examined in a latter section of this paper.

These indications of a lack of prime interest in the regulation of nonprofit entities help to explain regulatory failure. Serious implications flow from this fractured environment for the reliance of other government agencies on the regulation that is formally the responsibility of another. The agency incorporating nonprofit entities, for example, may be relied on to scrutinise the fidelity of such entities by other agencies. These agencies may have responsibilities for regulating other activities of that entity, such as the conduct of fundraising, gambling, taxation or providing funding. To avoid duplication they may assume that such regulation is being carried out and regulate accordingly. If this is not the case they may decide to regulate as well in that area. The situation arises where the regulation amongst fractured agencies is not co-ordinated. Reliance placed on other agencies is often misplaced. If no reliance is placed on other agencies, then duplication of regulatory effort occurs.

HALO

This section describes the behaviour of administrators, that results from the social and cultural norms associated with charity. The societal perception of charitable organisations being "good", "worthy", "moral", "altruistic", "philanthropic", "compassionate", "loving", "caring" and "beyond reproach" has significant implications for those who seek to regulate such organisations. Such widely held perceptions lead to nonprofit entities and charities in particular, having an "aura" or "halo" which tend to give them saintly qualities.[69] This section examines the evidence for the halo and its recognition by administrators. The section then examines the effect the halo has on conventional external strategies for monitoring and control, such as punitive sanctions, inspection, and adverse publicity. This is illustrated by reference to materials from the National Safety Council case study.

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[67] For example the 1992 Annual Report is 76 pages long and includes only 17 words about the administration of the acts.

[68] Commonwealth of Australia, `Annual Report of the Australian Security Commission', 1992, AGPS, Canberra; does contain a figure on the number of registrations of companies limited by shares which are mostly nonprofit companies at p.80, but it does not distinguish between companies limited by shares and companies limited by guarantee and shares. It does not disclose "Australian Registered Business Names" which are probably entirely nonprofit entities.

[69] The word `halo' commonly means a disc of light that surrounds the head in representations of the Christ and Saints. The halo is used extensively in religious icons, clearly depicting the ideal glory with which a person is invested. In the mind of the public, gratuitous intermediaries take on a halo because of their links with philanthropy, altruism, pity, compassion, generosity, sympathy and empathy which are emotionally powerful when linked to areas of concern for a society such as its very young, sick, elderly, the deserving distressed of society and animals.

One source of evidence for the halo is to be found in public inquiries. Most wax lyrical about the philanthropic and altruistic motives of charities and their donors in the welfare of society. Perhaps the most eloquent exploitation of the halo is found in the Nathan Report which devoted its first chapter to the value of charity in modern social structure.[70] The chapter measured the maturity of a civilisation by the state of its charity[71] and claimed the urban poverty of the industrial revolution "was swept back with a broom by the valiant ... efforts of charity."[72] To those who might be sceptical of the place of charity within society, the Report stated,

> *Indeed, we think that those who deny its importance can have but scant understanding of the historical process or of the forces which make for social cohesion, enrich social life and deepen social responsibility.*[73]

Over thirty-five years later, with an accompanying ideological shift from the welfare state to the economic rationalist views of the Thatcher government, a similar but shortened homily to the virtue of charity appears in the White Paper on Charity.[74] Phrases such as "enormous importance in the history of this country, and it remains so today", "plays a crucial role in engaging and directing the efforts of individuals who wish to help those in need", "pioneering efforts of the voluntary sector" give an indication little has changed.[75] These sentiments are acknowledged in varying degrees in other jurisdictions by similar public inquiries.[76]

There is evidence this presumed predisposition to sentiment and securing the high moral ground demonstrated by inquiry reports has also been adopted by regulatory agencies. The first sentence, for example, of the Charity Commission's corporate mission statement is, "Charity is precious in the life of a nation", and ends with its primary mission, "... so we can say to one and all, **You can trust charity**."[77] The Commission's mission is to ensure the maintenance of the halo, as much as it is to regulate conduct.

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[70] Great Britain, `Report of the Committee on the Law and Practice relating to Charitable Trusts', Cmd. 8710, HMSO, London, 1952, at pp.7-15, (hereinafter referred to as the Nathan Report).

[71] *Ibid.*, at p.7.

[72] *Ibid.*, at p.9.

[73] *Ibid.*, at p.14.

[74] Great Britain, `Charities: A Framework For the Future', Cmd. 694, HMSO, London, 1989, at p.1.

[75] *Ibid.*, at p.1.

[76] For example, Filer Commission, Vol. 5 p.2575; Victoria, `A Report to Parliament on the Law Relating to Charitable Trusts', No.54, Government Printer, Melbourne, 1989 at p.3; New Zealand, `Report to the Minister of Finance and the Minister of Social Welfare by the Working Party on Charities and Sporting Bodies', New Zealand Government Printer, Wellington, 1989, at p.80.

[77] `Role and Functions', Charity Commissioners for England and Wales, HMSO, London, 1989 at p.1.

The phenomena of the halo is also commented on in a number of academic works. Mendelson noted,

> *the image of a nonprofit carries with it a halo of probity in a capitalist society; one imagines the gentle administrator of a church-owned nursing home who spends his time in good works for the benefits of his patients, rather than in calculating new ways to beat the government.*[78]

Other scholars have also incidentally noted the role played by trustworthiness of nonprofit organisations.[79] *Forbes* magazine which initiated an annual listing of the "Top 500" American nonprofit organisations accompanied its first list with an article entitled, *Businessmen with Halos*.[80]

The importance of trust is intuitively recognised by those who control nonprofit organisations and the identified legal devices are promoted by additional strategies enhancing the perception of trust for donors.[81] This self-generated promotion of the entity as "trustworthy" further reinforces and maintains an organisational halo.

The importance of the halo can be appreciated by the consequences of the destruction of trust. Loss of trust may mean the ability of the nonprofit entity to attract donors is vastly reduced and even results in the death of the entity. Examples abound of such charities whose trustworthiness has been questioned resulting in dire financial consequences.[82] The reaction to the destruction of the halo is often greater than the response to a similar transgression from other than a nonprofit entity. This was perceptively noted by Ellman in an article seeking to rebut Hansmann's thesis on the economic function of nonprofit corporations as,

> *theft or embezzlement by a pastor, a March of Dimes organiser, or a Salvation Army Santa Clause evokes a distinctive outrage. That same feeling is not generated by the self-*

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[78] M.A. Mendelson, *Tender Loving Greed*, ?, New York, 1974 at p.195, cited in A. Etzioni & P. Doty, Profit in Not-for-profit Corporations: The Example of Health Care, *Political Science Quarterly*, Vol.91, No.3, 1976, pp.433-453.

[79] I.R. Ellman, *op. cit.*, at p.1018; Chesterman, *op. cit.*, at p.307; H.L. Oleck, *op. cit.*, at p.233; Hansmann, `The Role of Nonprofit Enterprise', *op. cit.*, at p.580. J.G. Simon, `Modern Welfare State Policy Toward the Nonprofit Sector: Some Efficiency - Equity Dilemma, in The Third Sector: Comparative Studies of Nonprofit Organisations', ed. H.K. Anheier & W. Seibel, Walter de Gruyter, Berlin, 1990, at p.38.

[80] J. Cook, `Business with Halos', *Forbes*, 26 November, 1990, pp.100-104. It notes that, "These institutions [nonprofits] come armed with what the for-profit sector calls the halo effect: Because of the purity and nobility of their goals, most people expect them to provide superior quality and services." at p.100.

[81] For example having members of the community who are believed to be beyond reproach on the management of the gratuitous entity or endorsing its activities. This is a fundamental strategy in any fundraising campaign. Patrons in the form of the Monarch, head of state or political leaders are also devices to reinforce trustworthiness.

[82] For example in America, the United Way scandal with allegations of over remuneration of management, K.A. Goss, `A Crisis of Credibility for America's Non-profits', *The Chronicle of Philanthropy*, Vol.V, No.17, 1993, at p.1; Covenant House scandal with allegations of sexual and financial impropriety, W.A. Baker, `The Wider Implications of Covenant House's Troubles', *Chronicle of Philanthropy*, Vol.II, April 17 1990 at p.30, `Covenant House Cuts Staff and Programs', *Chronicle of Philanthropy*, Vol.II, June 12 1990, at p.15; P. Bayless, `Directors Face Heat in a Charity Crisis: Covenant House', *Crains New York Business*, Vol.6, No.1, 26 February 1990 at p.30.

> *dealing of a business corporation director, reprehensible as we may believe it is. The difference lies in the special insult we feel when everyday evil, which we may learn to watch for, sneaks up on us disguised as virtue.*[83]

In the case of the NSC the authorities were reluctant to act on the press reports and complaints because they would be seen to be defiling the reputation of a worthy community organisation. Administrators who live with the day to day realities are aware of the consequences of adverse publicity for a nonprofit entity. In the short term, donees may fail to receive volunteer labour, grants and donations. This results from donors refusing to transfer property through a suspect nonprofit entity because of lack of trust. This is further exacerbated where there is no other nonprofit organisation to substitute for the blemished entity. To bring to the attention of the public or even the board of a nonprofit entity regulatory transgressions, may have serious consequences for donees and the entity itself. It may also have serious consequences for the state and its administrators. The state may have to fill the gap in services and administration subjected to an inquiry into the particular matter and regulation generally.[84]

HALO AS A POWER SOURCE

Nonprofit entities can use their halo to direct effective pressure on administrators and politicians. Chesterman notes of the Charity Commission that,

> *Even the potentially strong compulsive powers - for example, the power to order accounts to be submitted on the pain of contempt proceedings - are unlikely to be invoked too often because the commissioners do not want to appear to be treading too hard or too frequently on the toes of charity trustees.*[85]

H.L. Oleck writes of American administrators that,

> *State attorneys-general practically shun investigations of non-profit organizations. If they do investigate them, they make powerful enemies; if they punish them, they make vindictive enemies of the richest and most influential people and organizations in the state; and if they stop abuses they thereby stop up the wells of charity, and we are damned for doing that (not that they do it hardly at all).*[86]

The last statement also introduces a commonly used threat that greater accountability and scrutiny of nonprofit entities will cause the "voluntary spirit" to dry up. Here the threat is their work will cease,

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[83] I.R. Ellman, *op. cit.*, at p.1018.

[84] This point is recognised by Ware in his chapter on regulation of Intermediate Organisations, A. Ware, *Between Profit and State: Intermediate Organisations in Britain and the United States*, Polity Press, Oxford, 1989, at p.202.

[85] Chesterman, *op. cit.*, at p.307.

[86] H.L. Oleck, *op. cit.*, at p.233.

either harming donees or forcing the state to step in to supply such property. This strategy has been used effectively to thwart the implementation of inquiry recommendations.[87] The threat has even been accepted as the basis for immunity from civil suit for gratuitous intermediaries and their members.[88] The argument is, if volunteers of nonprofit organisations are exposed to liability, then they may not volunteer their services which would lead to inappropriate consequences for donees and the state. This threat of withdrawal again influences the administrator in the use of punitive sanctions or publicity to regulate nonprofit entities.

The National Safety Council case study indicates the pervasiveness of the halo phenomenon. In 1986 the National Safety Council Victorian Division sought to alter its constitution to permit it to engage in a commercial leasing arrangement of its specialised forest firefighting planes to a Canadian company during the Australian winter. The National Companies and Securities Commission Procedures Handbook required proposed amendments to licensed companies' constitutions to be approved by the Commission.[89] The provisions set out that the whole constitution was to be reviewed to ensure that all the latest administrative guidelines were meet.[90]

Officers of the Victorian Commissioner of Corporate Affairs carried out a review of the constitution of the company. They concluded many aspects of the organisation's constitution did not comply with the procedures manual and required major revisions.[91] The National Safety Council responded to this administrative requirement with a campaign against the imposed constitutional changes by a number of effective lobbying strategies. Its "in house" company lawyer made a lengthy legal submission to the Commission arguing legally that the Commission's actions were unduly restrictive and then relied heavily on the organisation's "halo".[92] Restricting the National Safety Council from operating in various ways was portrayed as not only harming the company, but leaving Australians prey to the ravages of summer bushfires and denying them access to lifesaving overseas technology.[93] This was followed by many references and letters from friends of the Council. Hospital Registrars, Chief Fire Officers, Directors-General of other government departments, the Federal Department of Defence and on Air Vice Marshal are just some of those that supported the National Safety Council.[94]

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[87] Chesterman, *op. cit.*, at p.406.

[88] Victoria, `A Report to Parliament on the Public Liability of Voluntary Organisations', Legal and Constitutional Committee of the Victorian Parliament, No.50, Victorian Government Printer, Melbourne, at p.3; R. Tremper, *Reconsidering Legal Liability and Insurance for Nonprofit Organisations*, Law College Education Services Inc, Lincoln, Nebraska, 1989, Appendix D and pp.27-35.

[89] `Companies Act and Codes Procedures Handbook', Section 66 Companies, Staff Paper 808, National Companies and Securities Commission, 1982 at p.808515.

[90] *Ibid.*, at para. 3.02.05.

[91] Commissioner for Corporate Affairs to Mr M. Quigby, Solicitor for National Safety Council of Australia, Victorian Division (Corporate Affairs Office file), dated 3 August, 1987.

[92] Kerry Pollard, Legal Officer of National Safety Council of Australia Victorian Division to Commissioner for Corporate Affairs (Corporate Affairs Office file), dated 13 October, 1987.

[93] *Ibid.*, at p.7.

[94] Letters on file with Victorian Corporate Affairs Office, National Safety Council Victorian Division - correspondence file.

The State Council of the National Safety Council included an impressive list of over thirty representatives from such organisations as the Australian Institute of Management, Australian Medical Association, Commonwealth Government Departments of Aviation and Transport, Victorian Government Departments of Conservation Forests and Lands, Health and Transport, Gas and Fuel Corporation of Victorian, State Insurance Office and Victoria Police to name just a few.[95] It had Vice-Regal patronage. The chair was a former mayor with an M.B.E. and in 1988 the chief executive, Friedrich was awarded an Order of Australia.[96] All contributing to the halo of the National Safety Council.

The matter of alterations to the constitution was placed before the National Companies and Securities Commission who acquiesced to the National Safety Council's submissions, with the Victorian Commissioner not making any submission on the matter.[97] The National Safety Council was able to operate substantially outside the policy guidelines, which according to the judge contributed to the extent of the massive fraud.[98]

The halo is not confined to administrators, but affects many others who may have some controlling power. The National Safety Council's relations with astute commercial financial institutions is also tainted with the use of the halo. The National Safety Council Victorian Division approached twenty-seven Australian and international financial institutions for loans worth millions of dollars. The halo helped induce these financial institutions into making huge loans. The State Bank of Victoria's officer wrote in an internal bank memorandum,

> *NSCA's status (non profit-making and tax exempt) and its role as a provider of community service in the fields of health, safety and emergency services render it for practical purposes a quasi government body. It has developed and grown to such an extent that it has in my view become indispensable.*[99]

The judge in one case relating to the fraud noted,

> *Arrant propaganda by Friedrich secured the confidence of officers of the State Bank of Victoria, who were led to regard loans to the company as virtually without risk. In particular the bank was influenced by the composition of the State Council of the company (which included nominees of government departments), the calibre of its supposed*

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[95] *Commonwealth Bank of Australia* v. *Friedrich & Ors* (1991) 9 ACLC 946 at p.960.

[96] *Id.*, at p.964.

[97] Commissioner for Corporate Affairs (Victoria) to The Chairman, National Companies and Securities Commission (Corporate Affairs Office file), facsimile dated 18 November, 1987, on file with the Victorian Commissioner of Corporate Affairs.

[98] *Commonwealth Bank of Australia* v. *Friedrich & Ors.* (1991) 9 ACLC 946 at p.975.

[99] *Id.*, at p.984.

> *directors, its supposedly indispensable place in the community and invulnerable position in an almost competitor-free market.*[100]

The halo phenomenon induced a lack of customary caution, short cutting, ineffective security monitoring on the part of, not just one, but over twenty five substantial financial institutions. This organisation was not perceived as a commercial market participant, but a trusted and revered social entity that could do no wrong.

A study of the case reveals a further influence of the halo phenomenon on the making of policy. In the Victorian Commission's report on reform to legislation and administrative practices to prevent a similar case recurring, it warned,

> *Experience shows that a majority of companies with a section 66 licence jealously guard their privilege to delete the word "limited" (if not the exemption from filing accounts). Any attempt to repeal the Section can be expected to generate significant and vocal opposition from influential community groups.*[101]

and concluded,

> *Any move to revoke such exemptions can be expected to meet with vocal and influential opposition, with the most vocal section in Victoria probably coming from the large private schools.*[102]

The halo of nonprofit entities and the administrator's aversion to standard punitive responses results in administrators adopting strategies akin to the gentle counselling of saints on how to better achieve their heavenly tasks, rather than to their traumatic excommunication.

Several commentators and inquires have noticed this attribute in relation to the English Charity Commission. Douglas and Wright commented that the Charity Commission mostly has,

> *an incentive to maintain good relations with charities and their trustees.*[103]

with the Commissioners perceiving their role as,

> *essentially as a supportive agency, advising and persuading charities rather than dragooning them by compulsory regulation.*[104]

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[100] *Id.*, at p.984.

[101] Corporate Affairs - Victoria, memorandum to Victorian Attorney General. (On file with Victorian Commissioner of Corporate Affairs), date 17 August 1989, at p.2.

[102] *Ibid.*, at p.3.

[103] Douglas & Wright, *op. cit.*, at p.48.

[104] *Ibid.*, at p.52.

The `Tenth Expenditure Report of the Expenditure Committee 1974-5', noted of the Charity Commission that,

> *We feel that in living up to their self-imposed image of benevolent family solicitors the Commissioners have given perhaps too much of their legal duties as opposed to their responsibilities on other spheres.*[105]

Despite being goaded to change in that report, a latter Parliamentary Public Accounts Committee noted,

> *... I get the impression that not a lot has changed since that report twelve years ago. You are not supposed to be benevolent family solicitors, you are supposed to be the watchdog of public interests.*[106]

The Charity Commission's governing Act sets the ways of achieving their objectives, in the following terms,

(a) by encouraging the development of better methods of administration,
(b) by giving charity trustees information or advice on any matter affecting the charity, and
(c) by investigating and checking abuses.[107]

The first two objectives sit comfortably with the actual practice of the Commission. Their perceived role as adviser to charity is reflected by the deployment of the Charity Commission's staff of 330, with only 8 staff employed on the examination of accounts and investigation of abuse and a "high proportion of resources directed to those divisions responsible for the Commission's quasi-judicial and advisory functions".[108] This feature is also discernible in Australasian jurisdictions[109] where a report on the form of association legislative reform noted,

> *So, as far as possible, the accent should be on simplicity, informality, and inexpensiveness, and on encouragement to incorporate rather than the need to satisfy high standards. It should be administered in an atmosphere of advice and encouragement, rather than*

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[105] United Kingdom, `Tenth Expenditure Report of the Expenditure Committee, 1974-5', *op. cit.*, at p.8.

[106] United Kingdom, Sixteenth Report from the Committee of Public Accounts, `Monitoring and Control of Charities in England and Wales', HMSO, London, 1988 at p.5.

[107] Section 1 *Charities Act* 1960 (U.K.).

[108] United Kingdom, National Audit Office, `Monitoring and Control of Charities in England and Wales', Cmd. 380, HMSO, London, 1987, at p.9.

[109] New Zealand, `Report to the Minister of Finance and the Minister of Social Welfare by the Working Party on Charities and Sporting Bodies', New Zealand Government Printer, Wellington, 1989 at p.68.

> *policing.*[110]

Another recommended that,

> *... this separate independent body may be able to discuss matters informally with trustees as well as providing advice and opinions.*[111]

Chesterman while identifying the administrator's behaviour, perceives the Commission's conservative, non-interventionist stance as a result of the incompatible roles as a "friendly" adviser and supervisor.[112] This paper suggests the emphasis on "friendly" adviser flows also from the difficulties of supervision of gratuitous intermediaries relating to the halo phenomenon rather than an incompatibility of the two roles.

An alternative analysis of this situation might be to apply capture theory as an explanation of the behaviour.[113] Capture theory propounds that regulation in the public interest may not be achieved because in the process of regulation the regulatee comes to control or dominate the administrator or even co-opt the administrator into a mutually shared perspective. The previous analysis in this paper points to the nonprofit entity and the administrator sharing a perspective which enables a mutually supportive co-existence. This is not the result of any co-ordinated intentional lobbying process but due to the inherent characteristic flowing from nature of these sorts of organisations.

The halo phenomenon thus has important consequences for administrators and influences the regulatory strategies that they employ. In devising the legal framework and regulatory strategies, the halo phenomenon should be acknowledged and taken into account. If it is not, administrators will be encouraged into behaviours that do not appropriately regulate nonprofit entities.

A QUIET BACKWATER

Lack of resources is a consistent reason given for the regulatory failure of administrators to scrutinise and control nonprofit entities. The evidence of inquiries in England, United States, Australia and New Zealand all observe that administrators have lacked resources necessary for functions such as the maintenance and scrutiny of registers, investigations and pro-active audits.[114] This is corroborated by

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[110] New South Wales Law Reform Commission, `Unincorporated Associations - Memorandum and Draft Legislation', Sydney, 1977, at p.31.

[111] Victoria, Victorian Legal and Constitutional Committee, `A Report to Parliament on The Law Relating to Charitable Trusts', Victorian Government Printer, Melbourne, 1989, at p.84.

[112] Chesterman, *op. cit.*, at p.307.

[113] R. Posner, `Theories of Economic Regulation', *Bell Journal of Economics and Management Science*, Autumn, 1974, pp.335-358; P. Quirk, *Industry Influence in Federal Regulatory Agencies*, Princeton University Press, Princeton, New Jersey, 1981; B. Mitnick, *The Political Economy of Regulation*, Columbia University Press, New York, 1980; G. Rowe, `Economic Theories of the Nature of Regulatory Activity', in R. Tomasic, (ed.), *Business Regulation in Australia*, CCH Australia Limited, North Ryde, Sydney, 1984.

[114] Chapter Three at p.123.

academic comment.[115]

Some have claimed that the task is impossible. The English Chief Commissioner explained to J. Douglas and P. Wright that,

> *it was manifestly impossible to expect the Commission to exercise any sort of detailed surveillance over some hundred and thirty thousand charities.*[116]

This explanation is unconvincing as strategies exist for other regulatory agencies, such as those supervising commercial companies, to deal with eight to ten times that number of entities with a fair degree of effectiveness.[117]

The lack of resources is a fact, but what has caused resource shortfall? One answer may be that the administrators may, as they claim to inquiries, receive insufficient funds from the government. Alternatively, it may be that administrators do not prioritise the given funds for charity regulation, but for other ancillary purposes. It probably is a combination of both explanations. The reasons for this behaviour are varied, but it is reinforced by the halo phenomenon.

There is a situation which could be described as a "backwater" phenomenon.[118] The backwater phenomenon describes the relative lack of importance to overtly regulate gratuitous transfer intermediaries for politicians or administrators. Such policies are not of great importance to the electorate and are not included in political policy platforms. For politicians it is a policy backwater compared to the regulation of crime, commercial fraud, taxation, industrial relations or welfare security. McKay illustrates this point by describing the delays with a New Zealand Inquiry,

> *It is of course quite understandable that a review of the Charitable Trusts Act should not be seen as a matter of urgent priority if only because there is no obvious outcry for public reform. Yet the elapse of eleven years - and the review is still of course not concluded - is surely too long for even a low-priority item. If the reference was worthwhile at the outset,*

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[115] Chesterman, *op. cit.*, at p.308; McKay, *op. cit.*, at p.198; H.B. Hansmann, `Reforming Nonprofit Corporation Law', *op. cit.*, at p.601; J.J. Fishman, *op. cit.*, at p.699.

[116] Douglas and Wright, *op. cit.*, at p.50.

[117] For example, The Australian Securities Commission regulates over 850,000 companies and the British Department of Trade and Industry over 998,000. There is still a degree of regulatory default on these registers, but the administrators have not conceded that the task is impossible. It will be recalled that charity registers were compared with for-profit corporate registers in Chapter Three, refer p.113.

[118] The term "backwater" is adopted from comments made in United Kingdom, Tenth Report from the Expenditure Committee, `Charity Commissioners and Accountability', HMSO, London, 1975, at p.xxix; Chesterman also uses the notion, M. Chesterman, `Regulation of Charities: Models Here and Abroad', in *Charities and Philanthropic Institutions: Reforming the Tax Subsidy and Regulatory Regimes*, ed. R. Krever & G. Kewley, `Comparative Public Policy Research Unit Monash University & Australian Tax Research Foundation', Melbourne, 1991, at p.81 where he writes, "The word `backwater' has been used more than once in the literature about charity regulation departments - I certainly heard it when I was doing work in this area in England and I have heard it again here."

> *it was surely worthy of more expeditious treatment than it has received.*[119]

It must also be borne in mind politicians use nonprofit community organisations to provide a presence and power base in the community, often feeding off the halo for their required positive electoral image.[120] Again such a factor mitigates against any political desire to actively stir the still pond of current regulatory practices.

This lack of a political imperative translates directly into a lack of funder's priority for the regulation of nonprofit entities. The halo phenomenon also explains the reluctance of politicians to be seen persecuting nonprofit entities by officious regulation. Thus for funds from the government, it will be unlikely regulation of nonprofit entities, will be generously or even adequately funded given its lack of political importance and the political risks of offending constituencies.

This stance of politicians is reflected in the behaviours of administrators. This is further exacerbated by most regulation being located in fractured agencies, with nonprofit regulation not one of their core activities. Generally scarce resources are prioritised to core functions at the expense of peripheral functions. Even the centralised Charity Commission has been characterised as "a quiet backwater" with,

> *a considerable turnover in staff in the junior echelons but at senior level there is stability.*[121]

These under-resourced administrative units out of the main policy stream are not perceived as desirable positions either for their status or the prospects of further promotion. The halo phenomenon inclines administrators to the giving of advice, rather than undertaking pro-active regulation which could cause undue repercussions for administrators. The halo phenomenon and the lack of resources combine to ensure that "the watchdog of public interests" behaves as a firm of "benevolent family solicitors".[122]

Resources are lacking for administrators, but this is not entirely the fault of politicians. Administrators have allocated the given resources in a way to limit the existence of pro-active regulation and enhance other more comfortable functions. The institutional nature of the nonprofit entity and the administrative agencies together with the state's reluctant to bear the transaction costs of contracting and monitoring on behalf of donors, combine to contribute to the regulatory failure.

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[119] L. McKay, `Comment: Proposals of the Property Law and Equity Reform Committee Working Paper on the Control and Supervision of Charitable Trusts', *New Zealand Universities Law Review*, Vol.8, 1978, pp.198-210 at p.198.

[120] T.R. Ireland, `The Calculus of Philanthropy', in *The Economics of Charity - Readings, Institute of Economic Affairs*, London 1973, pp.65-78 at p.69.

[121] United Kingdom, Tenth Report from the Expenditure Committee, *op. cit.*, at p.xxix.

[122] United Kingdom, Sixteenth Report from the Committee of Public Accounts, `Monitoring and Control of Charities in England and Wales', HMSO, London, 1988, at p.5.

STATUTORY RIGOUR MORTIS, CLONING AND REGULATION

One of the consequences of charity law being a policy backwater is its legislative reform is not driven by powerful stakeholders and is usually initiated by the state. Many of the reforms to nonprofit entities have occurred at times when it is in the interests of the state to have philanthropic gifts directed to certain areas of society.[123] Admittedly, the state has also to consider established charities that can wield the influence of their halo when necessary to protect their interests, but in comparison to other lobbies from commerce they are not as aggressive or active with respect to their own regulation. The social welfare lobby[124] is well organised in Australia, but has never seriously pursued the regulation of nonprofit entities.[125] It is contended Australian charity law reform has had a low priority and this has contributed to regulatory failure. This reform not only includes the legal infrastructure, but also the framework for the monitoring and control by administrators. It is characterised by statutory rigor mortis and precedential cloning.

Statutory "rigor mortis" describes a situation where the statutes providing for regulation enter suspended animation. It is characterised by lack of any priority for reform in its own right. Further where the statutory provisions are contained in a fractured administrative agencies' general statute, charity issues are overlooked when reforming the rest of the statute. There is also judicial rigour mortis where common law enters suspended animation which will be discussed in a later section of this paper. Judicial rigour mortis is amply demonstrated in an analysis of the definition of charity.

The period between reform of charity law in England and in particular direct regulatory powers and strategies of administrators is lengthy. Until the recent inquiries[126] there has been little imagination as to the appropriate style of regulation necessary for nonprofit organisations. The American jurisdiction shows similar slack, but can boast of an invigorated debate on the appropriate regulatory strategies for nonprofit organisations and a statutory definition of charity led by the Internal Revenue Code.[127]

In Australasia the regulatory statutes not only suffer from rigour mortis, but have been subject to some inappropriate copying from English sources. Precedential cloning describes the process of meticulous

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[123] This theme is illustrated by the interest of the state in Tudor England, Nineteenth Century England and the Thatcher government.

[124] For example the Australian Council of Social Services Inc., A.C.R.O.D. and Aged Care Australia. One exception to this is the Victorian Council of Social Service between 1978-1983 in its efforts to have an incorporated associations statute enacted.

[125] For example in the 1993 election campaign the opposition parties proposed a general consumption tax. The welfare lobby played an important part in lobbying against the tax, but from the perspective of their welfare clients rather than its effect on gratuitous transfer intermediaries.

[126] That is, since the 1987 Comptroller and Auditor General's Report, `Monitoring and Control of Charities in England and Wales', National Audit Office, HMSO, London, 1987.

[127] For example the `Model Nonprofit Corporations Law', The Subcommittee on Model Nonprofit Corporation Law of the Business Law Section, American Bar Association, Revised Model Nonprofit Corporation Act, 1987, Prentice Hall Law & Business, New Jersey, 1987.

transplanting of British laws into Australian states, particularly from the colonial period to the Second World War. The theoretical framework of the Australian state, parliament, judicial system and bureaucracy was still intertwined with the British Crown and resembled the British model, but the reality of the environment of the Australian states was altogether different. The economy, capital infrastructure, social forces and natural environment were poles apart.

This led to some odd results, such as the mortmain laws being applied in a colonial outpost almost devoid of a threat of religious bodies locking up vast tracks of taxable land under a "dead hand."[128] The Queensland Collections Act Regulations[129] contains a series of outdated prescriptions such as "no collector shall use a collecting box at the end of a pole".[130] This is a cloning of the Regulations of the English Metropolitan Streets Act of 1903[131] repealed in 1963[132], the object of which was to prevent the soliciting of donations from double decker trams, buses and coaches and from the upper storeys of terrace houses. Queensland has never had upper storey terrace houses or double decker public transport, with few horse drawn coaches. The provision still exists in Queensland, despite its lack of purpose in a very different society and despite it having been repealed some thirty years ago in England. This may be harmless regulation but it is symptomatic of the phenomena of cloning and rigor mortis.

Legal cloning also has stifled suggested statutory reform initiatives because there has been no statutory provision in England. Again the definition of charity provides an illustration. The Victorian Chief Justice's Law Reform Committee examined charitable trusts in 1962, prompted by the Nathan report and the adoption of the Charities Act (UK, 1960). The Report noted as its impetus that,

> *we have to consider whether we should adopt the provision of that Act or some of them.*[133]

Apart from recommending most of the English statutory reforms, the Victorian Chief Justice's Law Reform Committee also agreed with the conclusions of Nathan that drafting a satisfactory definition of charity was "beyond human ingenuity".[134] Despite being presented with cogent arguments for a statutory definition, the Law Reform Committee's Report concluded,

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[128] A.H. Oosterhoff, `The Law of Mortmain: An Historical and Comparative Review', *University of Toronto Law Journal*, Vol.27, 1977, pp.257-334; *Religious Educational and Charitable Institutions Act, 1861* which adopted mortmain style laws in Queensland.

[129] *The Collections Act* 1975 (Qld.).

[130] *The Collections Act* 1975 (Qld.), reg.21(d).

[131] *Metropolitan Streets Act* 1903 (U.K.).

[132] *Local Government Act* 1963 (U.K.). Also see the comment on this provision in P. Luxton, *Charity Fund-Raising and the Public Interest: An Anglo-American Perspective*, Avebury, Aldershot, 1990, at p.28 of also M. Chesterman, `Regulations of Charities: Models Here and Abroad', *op. cit.*, at p.82.

[133] Victoria, Chief Justice's Law Reform Committee (Victoria), `Report on Charitable Trusts', Melbourne, 1965, at p.1.

[134] *Ibid.*, at p.4.

> *We think we should firmly resist the blandishments of those who put logic first and disregard history. But there is in our view an even more compelling reason for not attempting to frame a definition. We consider that in this field we should not depart from English Law. As matters stand, we have the great benefit of decisions given in the courts of Great Britain. We have in the past received great guidance from the decisions of such courts and no doubt will continue to do so.*[135]

This Report has been cited as a good reason for the failure to attempt a statutory definition of charity for the next twenty-five years in Victoria and other states. The New South Wales Review of the Charitable Collections Act,[136] the first and second reports of the Victorian Interdepartmental Working Party[137] and the Victorian Parliamentary Committee[138] all place much store on the Victorian Chief Justice's comments. There has been some marginally tinkering with a statutory definition in some Australian states, but no conceptual reformulation.

The National Safety Council case study illustrates the regulatory problems created by the cloning of statutes and the resulting rigor mortis. The National Safety Council Victorian Division was a company limited by guarantee with a licence pursuant to the Companies Act[139] to omit the tag "limited" from its formal title and also exempt from lodging annual financial returns and returns of office bearers. Such exemptions were available to certain charitable and nonprofit companies upon application for a licence. The judge found this attribute had led to the possible misrepresentation of the organisation as a government guaranteed instrumentality rather than a company with no issued capital and limited liability.[140] It also meant the financial accounts of a public company were not available for public scrutiny, as well as the auditor's qualification of previous accounts which would have certainly lead to investigation. This would have caught the situation at a much earlier stage and mitigated damage, if any.

This state of affairs came about directly through cloning of the statute without due regard for the circumstances in England and continued through statutory rigor mortis. The company limited by guarantee was an English corporate form established by the first English code of company law.[141] This legislation was almost copied word for word in its entirety by each of the states of Australia,

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[135] *Ibid.*, at p.5.

[136] New South Wales, Chief Secretary's Department, `A Review of the *Charitable Collections Act*', 1934, Sydney, 1989, at p.12.

[137] Victoria, `Administration of Charities', State Government Interdepartmental Working Party, First Report, Victorian Government Printer, Melbourne, 1980 at p.17; Victoria, `Administration of Charities', State Government Interdepartmental Working Party, Second Report, Victorian Government Printer, Melbourne, 31 March, 1982 at p.14.

[138] *Ibid.*, at pp.34-35.

[139] *Companies Act* 1915 (Vic.).

[140] *Commonwealth Bank of Australia* v. *Friedrich & Ors.* at p.975.

[141] *Companies Act* 1862 (U.K.), section 9.

shortly afterwards, except Western Australia.[142] The Queensland Attorney General when introducing such company legislation explained,

> *I consider that the mature consideration of English experts should weigh very seriously when people bring opposition to bear on the Bill. I take it that everybody who makes up his mind to oppose the Bill or to suggest alterative will take into consideration what has been done in England and that great weight should be given to the views of English experts.*[143]

Similar sentiments were expressed in the Victorian Parliament.[144] It is not unreasonable that a former colony with limited resources ought to look to a successful world power for legislative models, especially when their systems of government were interwoven, nor is copying of appropriate statutory provisions inherently wrong.

The flaw in adopting this particular legislation was the Australian states failed to appreciate other English regulatory bodies that had been established to supervise charities. Immediately prior to the establishment of the company limited by guarantee in 1862, the English Parliament created the Charity Commission.[145] The Charity Commission required returns and scrutinised accounts. The English administrative practice was the Board of Trade would not grant a licence to dispense with the tag "limited" unless the company was a registered or exempt charity under the Charities Act.[146] The Charity Commission will not permit companies limited by guarantee registered as charities to trade with the public.[147] There was no Charity Commission in Australian states and effectively there was no external administrative scrutiny of such organisations, and no restraints on trading with the public. The cloning of the company legislation and the exemption for companies limited by guarantee did not take into account complimentary legislation and administrative practices and it was only a matter of time before a major fraud occurred as a result of the provision.

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[142] New South Wales, 37 Vic. No.19, (*Companies Act* 1874); Queensland, 27 Vic. No.4 (*Companies Act* 1863); South Australia, 27 & 28 Vic. No.13, (*Companies Act* 1864); Tasmania, 33 Vic. No.22, (*Companies Act* 1869); Victoria, 27 Vic. No.190, *Companies Statute* 1864); Western Australia, No.82 of 1961, (*Companies Act* 1961).

[143] Queensland, Parliamentary Debates, Legislative Assembly, 8 September, 1931, p.673.

[144] The Hon. Mr Fellows MLC, referred to the legislation as a transcription of the *English Act*, Victoria, Parliamentary Debates, 9 February 1864, Vol.10, 1863-4, at p.68; The Hon. Mr Graves, Parliamentary Debates, 29 August 1883, Vol.43, 1883, at p.843; as cited in K.J. Levy, *An Historical Analysis of Incorporated "Non-profit" Entities in the United Kingdom, New Zealand and Australia with the Purpose of Raising the "Profit/Non-profit Debate"*, Minor LL.M Thesis, University of Melbourne, 1993 at p.50.

[145] *The Charities Act* 1960 (U.K.).

[146] Notes issued by the Board of Trade, p.1, reproduced in L. Berkowitz & G.D.M. Cockain, *Companies Limited by Guarantee and Unlimited Companies*, Oyez Publishing, London, 1977.

[147] This is on the basis that trading itself is not a charitable purpose, it does permit the sale of goods made by beneficiaries of the charity and small irregular trading such as fetes and jumble sales. If charities wish to obtain funds from commercial trading they are required to establish a separate business. England, The Charity Commissioners, Fundraising and Charities, CC 20, 1989 at pp.4-8; H. Blume, *The Charity Trading Handbook*, Charity Trading Advisory Group, London, 1981 at pp.193-195.

It was apparent to the regulators in the 1970s that the situation was fraught with danger and this is illustrated by refusal of such licences to be granted in all but exceptional circumstances.[148] It was not until the Corporations Law was proclaimed in 1990, after the National Safety Council fraud case, that licences would only be given to omit the word limited from a company's name.[149] The corporate number must however be used and it is possible that this will defeat the purpose of the company in omitting the word "limited".[150] In England if the company is a charity and its registered name does not include the word "charitable" or "charity" the fact a company is a charity must be clearly stated on all public company documents.[151] Statutory cloning and rigor mortis combined to directly contribute to the regulatory failure in the National Safety Council case.

Few jurisdictions can boast they have no instances of archaic or inappropriate legislation remaining on their statute books. In many instances the archaic legislation is ignored or so irrelevant that its effects are inconsequential. The lack of law reform addressing the regulation of nonprofit entities has far more serious consequences than the continuation of harmless irrelevant legislation. Once again this can be appreciated in the case study of the National Safety Council. The lack of law reform contributes directly to the regulatory failure of administrators to properly monitor and control nonprofit entities because of inappropriate statutory provisions.

INAPPROPRIATENESS OF EXTERNAL REGULATORY INSTRUMENTS

Administrators have regulatory instruments they use to monitor and control nonprofit entities. Such regulatory instruments might be the prohibition of certain activities without the grant of a licence often containing restrictive conditions, requiring periodic financial and management reports, criminal sanctions, adverse publicity and external inspection of the entity's records. Internal control instruments through membership, donor or donee participation in some entity forms are non-existent or seriously flawed. For example, the charitable trust has no members, donees and donors are actively discouraged and prevented from making the trustees accountable. Given the lack of internal regulatory control, it might be expected that the state would play a greater role in the supervision of nonprofit entities. It is contended in this section the external regulatory instruments employed by administrators are also flawed.

One category of regulatory instruments available to administrators are criminal sanctions. This is a common and traditional regulatory instrument used to encourage regulatory compliance. It may take the form of an automatic "parking fine" style sanction for the non-lodgement of an annual return to custodial sentences for controllers of defaulting entities and is widely used in regulation of for-profit

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[148] M. McGregor-Lowndes, `The Regulatory Compliance of Two Forms of Nonprofit Enterprise', Unpublished Master's Thesis, 1989, Griffith University, at p.67.

[149] *The Corporations Law* (Cth.), section 383.

[150] *The Corporations Law* (Cth.), section 372.

[151] Section 30C, *The Charities Act* 1960 (U.K.) inserted by section 11 of *Companies Act* 1989.

organisations.[152]

This paper has already examined the issues bearing on administrators which may make it difficult for them to be involved in any action which may destroy an entity's halo. The threat of criminal proceedings has the capacity to severely damage most organisation's halos. If penalties are imposed on gratuitous transfer intermediaries or their controllers, there is also the issue of adverse consequences for the innocent. For example if a nonprofit entity through a rogue employee fails to lodge annual returns and is therefore liable to a monetary penalty, it is the potential donees who will suffer, through no fault of their own. A similar situation arises with well intended, voluntary but legally ignorant managers who unintentionally default. Utilitarian ethical considerations of the potential consequences on the donees tend to present cogent arguments for discretionary leniency rather than an administrator's insistence on teleological ethical constructs of immutable principles.

It might be reasoned that the threat of criminal prosecution is a persuasive instrument to control such entities. Specific examples of criminal actions are rare and combined with the mostly voluntary and unsophisticated nature of managers who are often unaware of their legal responsibilities, the deterrent value of the threat of criminal action wanes. The traditional for-profit corporate regulatory model of using punitive criminal sanctions is inappropriate for the regulation of nonprofit entities.

Similar problems which are not as chronic as those found with nonprofit entities have been widely analysed in the context of for-profit corporate regulation. In the for-profit corporation context, innocent shareholders suffer for the sins of middle management and bringing criminal prosecutions is perceived as ineffective given the light non-custodial sentences given to white collar criminals.[153] Alternatives to criminal sanction have been suggested such as equity fines, internal audit procedures, corporate prohibition and Attorney General enforcement.

Some of these alternatives can be perceived in the often informal regulatory instruments used by administrators. For example in England, the Charity Commission can initiate a formal investigation into the activities of a charity, but prefer to seek the co-operation of management for an informal solution to a complaint.[154] This may result in an understanding as to the dismissal of certain employees, alteration of management practices or policies or some other mediated solution. This is also the case in New York where administrators will seek confidential consent orders which require

[152] It is still widely used regulatory instrument although there is a growing debate on whether to decriminalise the for-profit corporations law.

[153] J.C. Coffee, `Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions', *American Criminal Law Review*, Vol.17, 1980, pp.419-471; J.C. Coffee, `No Soul to Damn: No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment', *Michigan Law Review*, Vol.79, 1981, pp.386-459; R. Tomasic, `Corporations Law Enforcement Strategies in Australia: The Influence of Professional', *Corporate Law*, Vol.3, No.2, pp.192-229; R. Tomasic, `Sanctioning Corporate Crime and Misconduct: Beyond Draconian and Decriminization Solutions', *Australian Journal of Corporate Law*, Vol.2, No.1, pp.82-114; P. Grabosky & J. Braithwaite, *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies*, Oxford University Press, Melbourne, 1986.

[154] Cairns, *op. cit.*, at p.32; England, `Report of the Charity Commissioners for England and Wales for the Year 1989', HMSO, London, May 1990, at p.19; England, `Report of the Charity Commissioners for England and Wales for the Year 1990', HMSO, London, May 1991, at p.12.

the defaulting charity to behave in certain ways or risk of having the matter referred back for prosecution in the courts. The behaviour identified earlier of the use of advice to controllers of nonprofit entities by regulators is perhaps another useful part of a strategy to control gratuitous intermediaries.[155] It seems not to be the sole solution to the regulatory failure problem. In any case there is a promising path to follow in these alternative regulatory procedures given the problematic attributes of nonprofit entities.

Administrators license nonprofit entities acting as regulatory "gatekeepers". If an entity cannot legally carry on an activity without the approval of an administrator, it provides a tool to regulate entities carrying on that activity. This is a common regulatory instrument in occupations and all types of economic activities from primary agricultural production to manufacturing technologically sophisticated weapons. This paper has already pointed to issues involved in the licensing of nonprofit entities, such as the registers are not well maintained, monitored or appropriately conceived.

This point can again be illustrated by the National Safety Council case study. The National Safety Council was a company limited by guarantee which was not licensed as a charity, but under the regime of commercial corporate regulation. Because of the restricted definition of charity the NSC was classified under an inappropriate licensing system designed to regulate for-profit, not nonprofit entities. It was inappropriately regulated.

This problem is further complicated by extending the charity licensing regime to include companies, as has occurred in England.[156] Such entities are caught between two incompatible licensing systems which produces intractable legal and administrative problems for such entities and regulators.[157]

The National Safety Council case study also illustrates the common way around such problems of licensing gratuitous transfer intermediaries in commercially orientated regimes by exempting them from provisions which run counter to their purpose or activities. Such exemption leaves holes in the regulation of such entities that can lead to regulatory default. This has already been illustrated in this paper in relation to the National Safety Council being exempt from lodging annual financial returns and using the tag "limited" in its name.

As has been foreshadowed earlier in this paper, the model of regulation of the company limited by guarantee has been taken by default from the regulation of for-profit entities. The company limited by guarantee has been subject not only to a particularly commercial model for its legislation, clearly a non-halo jurisdiction, but also its regulators are a totally commercially orientated bureaucracy. This

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[155] This does not affect the argument in a previous section of this chapter concerning the use of such strategy to the exclusion of other monitoring functions. Such a strategy is only effective as an overall scheme for the regulation of intermediaries.

[156] *The Charities Act* 1960 (U.K.), section 46.

[157] J. Warburton, `Charitable Companies and the Ultra Vires Rule', *The Conveyancer and Property Lawyer*, Vol.52, July-August, 1988, pp.275-283; J. Warburton, `Charity Corporations: The Framework for the Future?', *The Conveyancer and Property Lawyer*, Vol.54, 1990, pp.95-105.

misalignment contributes again to the regulatory failure of nonprofit entities.

The creation of the English corporation by registration in the mid-nineteenth century was to serve the demands of the for-profit entrepreneurs. It was soon realised that many of the essential regulatory controls of for-profit corporations were found to be inappropriate for companies limited by guarantee. The legislative response was to relax these controls by exemption rather than designing appropriate regulation of a nonprofit entity. This response does not arise from a deliberate policy analysis of the issues raised by the facilitation and regulation of philanthropic intermediaries. Perhaps this is a little harsh on nineteenth century policy makers given that only recently has there been academic interest in the nature and functions of the nonprofit sector. It does not excuse current Australian policy analysts from continuing the legislative *rigor mortis*.

Inappropriate regulatory instruments have been used to monitor and control nonprofit entities. The traditional punitive criminal sanctions cannot be relied on as heavily as in other situations to produce compliant behaviour. Monitoring through registries and licensing has not to date been entirely successful. It is argued even if appropriate resources were devoted to such activities, the systemic definition of charity excludes some nonprofit entities from the regulation and forces them into inappropriate for-profit regimes. The for-profit regulatory regimes deal with the problems of nonprofit entities' non-fit with their regulatory strategies by exempting them. This effectively produces little appropriate regulatory monitoring and control of such entities.